

ABC, Inc.

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July 31, 1998

Government Affairs

Ms. Magalie Roman Salas  
Secretary  
Federal Communications Commission  
1919 M Street, N.W., Room 222  
Washington, DC 20554

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FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF THE SECRETARY

Dear Ms. Salas:

ABC, Inc., hereby submits for inclusion in the record of CS Docket No. 98-102 a report commissioned from Economist Incorporated, entitled "How Bundling Cable Networks Benefits Consumers".

The report reaches the following conclusions, which appear at page 21 of the report:

"Cable operators offer bundles or tiers of networks for several efficiency enhancing reasons. Bundling lowers transaction costs and enhances the value of the service of consumers. Bundling also reduces the technical costs associated with scrambling and descrambling devices relative to offering programs individually. There are also synergies for the operators and networks associated with selling advertising and promoting their services. Bundling reflects the economic reality that delivering programming to the viewer costs roughly the same regardless of the number of channels delivered - as long as those channels can be bundled. In sum, bundling substantially reduces per channel costs of cable programming. Forcing networks such as ESPN on to individual channels, far from benefiting viewers, would likely harm consumers, operators, and programmers.

Recent rate increases by cable operators do not signify market power and do not warrant the reintroduction of rate regulation or the delay of deregulation., Recent rate increases reflect the higher costs and improved quality of the products being offered by cable operators".

If there are any questions in connection with the foregoing, please contact the undersigned.

Very truly yours,

Sam Antar

SA/kh

cc: Alan Braverman

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Washington, D.C. 20554

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In the Matter of )  
Annual Assessment of the )  
Status of Competition in )  
Markets for the Delivery )  
of Video Programming )

CS Docket No. 98-102

Comments of ABC, Inc.

Alan N. Braverman  
Senior Vice President & General Counsel

Sam Antar  
Vice President, Law & Regulation

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July 31, 1998

# **How Bundling Cable Networks Benefits Consumers**

July 23, 1998

***ECONOMISTS INCORPORATED***  
1200 NEW HAMPSHIRE AVENUE  
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WASHINGTON, D.C. 20036

## EXECUTIVE SUMMARY

Recently, some commentators have expressed concern that cable rates have risen faster than the overall rate of inflation and have suggested that “unbundling” cable programming services would be an effective means to lower the cost of cable to consumers without impairing quality. This paper first provides an economic analysis of the bundling of cable channels and argues that mandatory unbundling is an inappropriate means to address concerns about cable rates and is likely to harm consumers. The paper then provides an analysis of recent cable rate increases and argues that the observed rate increases do not signify market power or warrant the reintroduction of regulation.

Suggestions that “unbundling” some or all cable programming services would lower the rates paid by subscribers reveals a misunderstanding of the economics of cable programming. In particular:

- Bundling is a commonplace and efficient method for delivering a wide range of products to consumers.
- Bundling is an economically efficient way to offer cable programming. It lowers transaction costs and equipment costs that would otherwise be borne by consumers and by cable operators.
- Bundling offers an enhanced product that most consumers prefer. It allows for occasional viewing of special news, sports, documentary, and movie programming.
- Bundling facilitates entry by new cable networks by allowing subscribers to sample new programming services.
- By expanding viewership, bundling allows for more effective advertising, creating an important source of revenue for operators.
- Bundling reflects the economic reality that delivering programming to the viewer costs roughly the same regardless of the number of channels delivered—as long as those channels can be bundled.

Because bundling is efficient and preferred by customers and networks, it follows that mandatory unbundling would:

- Raise rates to most consumers for whatever package of channels they eventually would choose.
- Reduce network programming expenditures leading to an inevitable reduction in program quality.
- Make advertising less efficient and less valuable leading to increased pressure on cable rates.
- Lower the quality and selection of the programming that viewers would have available.
- Impose unnecessary and burdensome additional regulations on cable operators, at a time when the appropriate public policy is a lessening of regulation.

Recent rate increases reflect both the higher costs and the improved quality of the products being offered by cable operators, and do not suggest any need for additional regulation. In particular:

- Rate increases for systems that do not face “effective competition” follow the same pattern as rate increases for systems that do face “effective competition,” using the 1992 Cable Act’s definition of those terms.
- On a per-channel-delivered, inflation-adjusted basis, cable rates have declined over the last several years, notwithstanding increased programming and other costs.
- Increases in cable viewership indicate that cable operators continue to deliver a product that subscribers want despite the increasing competition from direct-to-home satellite transmission services.

In sum, bundling reflects the economic incentives and preferences of both the networks and consumers. Mandatory unbundling would deliver none of its perceived benefits and indeed is likely to harm consumers.

# How Bundling Cable Networks Benefits Consumers

## I. BUNDLING OF CABLE NETWORKS

### Bundling is Commonplace and Efficient

Bundling occurs when goods are sold in fixed proportions. If one wants to subscribe to some cable networks one must subscribe to all the networks that come in the package or tier of service. Similarly, if one wants to buy the sports section of the *Washington Post*, one must buy the whole paper. There are many reasons why it is efficient for potentially distinct products to be sold as a unit. Potentially distinct products are bundled in order to lower transaction costs, exploit scale and scope economies, or enhance the attractiveness or convenience of the product to consumers. For example, shoes are typically sold with laces because it is more efficient (*i.e.*, lowers transaction costs) than to sell the two, shoe laces and shoes, separately. For another example, bundling of channels into tiers is hardly the only bundling that goes on in cable television. Each network or channel is itself a bundle of programs, each of which could in principle be sold separately using a pay-per-view system.

As suggested above, newspapers are a familiar example of an efficient bundle. Not everyone who purchases a daily newspaper reads each section and each section could be sold separately. But it is efficient to sell the sections in a bundle for at least three reasons. First, there are economies of scope in having all of the sections delivered at once rather than having separate deliveries for each section. Second, subscribers receive some value by having the *option* to look at all of the sections even if they usually do not read all of the sections. For example, some subscribers that typically do not read the sports section may read it during special events, such as the Olympics. Subscribers can avoid the transaction cost of having to call and get this section separately when they want it. Also,

there may be an article of interest in a section that they find by scanning through the paper that they would not see if the sections were not sold as a bundle. There is value to consumers in having this option. Third, by expanding the potential readership of the entire paper and by eliminating the need for duplicative advertisements, bundling also makes advertising more valuable and more efficient. Hence, for advertisers there is a synergistic effect of bundling.

Exploitation of market power is not a common reason for bundling. Almost every good and service available in the marketplace is a bundle of components, most of which could in principle at least be sold as separate products. Even when market power does exist, bundling often enhances economic welfare. It is useful to note that a regulation requiring a firm with market power to unbundle would have no effect on that firm's market power. Forced to unbundle, a firm with market power would still sell the components of the bundle at a monopoly price. Consumers would themselves have to supply the search, acquisition, and assembly services, with the result that the effective price of an assembled bundle would actually increase above the monopoly price of the bundle.<sup>1</sup>

### **Avoiding Transaction Costs and Other Benefits of Bundling**

Transaction costs are a primary reason behind the efficiency of bundling. In the case of cable television, all subscribers would face transactions costs and many subscribers would face additional technical equipment costs if bundling were not permitted. Transaction costs include collecting information about what types of programming are available on the various cable networks. In addition to the time needed to

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<sup>1</sup> There are more complicated circumstances in which a firm has a monopoly over some but not all of its components. In that case, some economists would argue that the firm might have an incentive to bundle in order to "leverage" its market power and to exclude competing suppliers of some components. Even if this were the case, it remains true that forced unbundling will likely make consumers worse off, because the bundling takes place not just to leverage market power, but also to reduce costs.

research the programming offered, the subscriber might have to pay more to compensate the cable operator for its increased marketing efforts. While the cable operator has an incentive to make this information available, providing this information to all subscribers is costly and the cost of marketing would likely be reflected in the rates charged for the individual channels.

There is also the transaction cost of having to call the cable operator to add or delete a cable network. This may occur because there is a new channel that the subscriber wants or because the subscriber no longer wants a channel currently being purchased. Again, in addition to the time spent dealing with the cable operator, there is likely to be a charge incurred for each modification to the channel line-up purchased since the operator is likely to have to add additional customer support and technical staff to deal with the increased number of calls.

In addition to these transaction costs, many cable subscribers will have to purchase or rent additional pieces of equipment. If most popular cable channels are offered a la carte then cable operators are likely to scramble their system's channels, which would require subscribers to use a converter or descrambler box. While some subscribers already have a box in order to receive premium or pay-per-view programming, less than one-half of cable households currently have addressable converters.<sup>2</sup> Subscribers without a box would have to buy or rent an addressable box for each television that they use to watch cable programming. The National Cable Television Association estimates that the rental rate of an addressable box is likely to be \$3.20 per month.<sup>3</sup> Hence, the additional cost to a household with two televisions would be \$76.80 per year, and the additional cost to a household with three televisions would be \$115.20 per year. Even those households that currently have an addressable converter

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<sup>2</sup> *Kagan Media Index*, Jan. 28, 1998, p. 8.

<sup>3</sup> This estimate assumes that an addressable converter box costs \$125, has an equipment life of 5 years, and the operator earns an 11.25 percent (after tax) return on investment.



box may face additional costs if they do not have a box for each television set that they use to view cable programming.

Cable television subscribers sign up for cable on the basis of some expectation about the nature of the service, but most new subscribers (perhaps most subscribers) are not familiar with the programming on each of the cable networks offered. Indeed, some may subscribe partly or chiefly for the *option* to view certain networks only during special programming events. Possible examples of such networks are CNN, C-SPAN, MSNBC and The Weather Channel. In any event, both new and established subscribers are buying certain services that they know and understand, as well as an option to sample all the remaining services. The option is valuable in itself, and there is some willingness to pay for it even though the consumer may be unfamiliar with each cable network. Of course, the option exists and conveys value only to the extent that the subscriber can (a) freely sample all the services in the bundle and (b) freely choose to consume any of the services, without incurring further search and transaction costs or fees.

Subscribers value the option to view specialized channels because they occasionally exercise that option. For example, cable networks that typically receive low levels of viewing can get ratings spikes when a special program is carried. These special programs could be major news stories, major sporting events, or special movies or documentaries. Such spikes in viewership represent subscribers exercising their option to occasionally view a particular network. The Appendix lists several examples of spikes in viewership.

In many respects, bundling enables the launch of new and previously unsampled programming services, contributing to the diversity of programming available to the public. New programming services benefit greatly from their association on the bundled tier with well established networks. It is through that association that new services have the greatest opportunity to be sampled and hence to find an audience.

## **Other Operator and Programmer Cost Savings**

As discussed above in the context of newspapers, expanding viewership makes advertising more valuable to the advertiser and in the case of cable to the cable network and the local cable operator.

There are other significant efficiencies that can be achieved through bundling channels into a single package. The structure of the production costs and the distribution technology in the cable industry create an incentive for operators to offer a set of channels as a package rather than a la carte. That is, bundling reduces operating costs. The outcome is beneficial not only for cable operators, but also for consumers in terms of a larger industry output and a lower average price per channel.

A portion of the cable operator's costs is the fee that has to be paid to a cable network for the right of carrying the signal. This fee often takes the form of an amount per subscriber and may decrease as the operator secures a larger audience for the network in question. Offering all cable networks as a single package allows the operator to maximize the number of subscribers for any given network and achieve the lowest possible license fee per subscriber.

Another cost incentive for bundling channels is the significant economies that can be achieved in the distribution of the signal to subscribers. The network and distribution cost entailed in serving an additional subscriber is the same regardless of the number of channels being delivered to that customer. This cost is recovered as part of the subscriber's bill. The more channels the household subscribes to, the lower the average distribution cost per channel. When a consumer subscribes to all channels she achieves the lowest possible distribution cost per channel. Offering all channels as a single package allows both the cable operator and subscribers to take full advantage of these cost savings. As a result, industry output under such a system is larger than if the operator is forced to offer individual channels a la carte.

From the point of view of economic welfare it is important to maximize the opportunity for viewing at a low or zero marginal cost,

while preserving incentives for programmers to invest. Programs are what economists call “public goods”—once a program exists, it costs nothing to let one additional viewer enjoy it. Therefore, it is inefficient to charge a price that excludes viewers who place any value on the program. Of course, there has to be a way to pay programmers, or there will be no programs. While not a perfect solution, bundling helps to solve this problem. Once a household is wired for cable, there is essentially no social cost associated with allowing the household to receive more cable signals. Viewers, for their part, would likely receive at least some positive enjoyment from the additional signals. There is therefore no social cost, and a probable social benefit, when households receive additional cable signals.

The average delivery cost per channel (i.e., production cost plus distribution cost) will always be larger under a system that forces cable operators to sell the individual channels individually. The reason is that, for a given channel, the license fee is constant or declines with the number of subscribers and, for a given subscriber, the distribution cost is being spread over fewer channels. Unbundling would give rise to a larger average price per channel, a smaller industry output and, therefore, lower consumer surplus.

It is hardly surprising that empirical experience bears out the notion that being part of the bundled service tier is important to the economic success of programming services. Pay services and pay-per-view services have often not been successful. In recent years there has been a migration of premium services onto the cable programming services tier. These services include Encore, Bravo, Disney and many of the regional sports networks. Most regional sports channels have moved from premium to basic status. For example, New England Sports Network, while still a premium channel in its core area, has moved to the tier outside of that area. The same applies to Home Team Sports, which is a premium service in Baltimore and part of the tier outside of Baltimore. Other examples include FOX Sports in the Bay area, Comcast Sports Network in Philadelphia, and Fox Sports in Detroit. Analogously, on-line

services such as AOL have moved from per-hour to flat rate pricing. It seems that for any given expenditure, consumers prefer not to have to deal with metered usage.

## II. EFFECTS OF FORCED UNBUNDLING

If bundling is efficient and is preferred by networks, operators, and consumers, it follows that forced unbundling will be inefficient and harmful to programmers, operators, and consumers. Mandating that a cable network be offered individually is also likely to reduce that network's advertising revenue and the cable operator's advertising revenue. The network will have to offset this revenue loss by increasing the license fee to the cable operator and by reducing the quality of its programming. The cable operator may try to compensate for this lost revenue by increasing subscriber rates. A further discussion is presented here using a single network, ESPN, as an example of the likely effects of mandatory unbundling.

If cable operators were required to offer ESPN (or any similar network) on an individual basis, subscribers to ESPN would likely pay a higher fee than the implicit fee cable operators currently charge. Even so, ESPN's subscription revenue is likely to fall. A cable network must consider viewers' relative demands when pricing an a la carte service to cable operators. In ESPN's case, the network has a pricing decision to make: either it can charge a high price and sell the service only to hard-core sports viewers, or it can lower its price in order to entice those who are only occasional viewers. To determine the relative profitability of the two pricing strategies, the cable network would have to ask whether, if it lowers its price, it could recoup the potential revenue it loses from serious sports fans with revenue from the low demand, occasional sports viewers. The answer may well be no, in which case the cable network would charge

a relatively high price for the stand-alone network, and only the hard-core sports viewers would receive the signal.

An unbundled ESPN is likely to generate less advertising revenue due to the elimination of casual viewers. From the perspective of a cable network reliant on advertiser support, bundling carries with it a major output-enhancing benefit. While some of the current audience for the network would still be there if the network were offered a la carte, another part of the audience is engaged in sampling activity, or consuming the network service infrequently. This group is not willing to pay for a subscription even though they do in fact, today, contribute to the audience. Forcing the network to operate a la carte implies a reduction in advertising revenue because of the reduction in audience. Other things equal this will reduce the funds available to acquire programming, and thus reduce the quality of programming available on ESPN.<sup>4</sup>

An unbundled ESPN is likely to cut back or eliminate niche sports programming. In order to broaden its appeal to occasional viewers, ESPN has tried to broaden the categories of sports that it offers, *e.g.*, women's college basketball and volleyball. A reduction in audience and revenues may force ESPN to focus on mainstream, broad-appeal programming to attract a core audience. This may hinder ESPN's ability to nurture the development of new sports categories.

Removing ESPN from the bundle of services is likely to significantly reduce the cable operator's local advertising revenue. Local cable advertising revenue totaled \$1.912 billion in 1997.<sup>5</sup> Advertising placed on ESPN accounted for the largest percentage of local ad inserts on cable networks, accounting for approximately 19 percent of all local cable

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<sup>4</sup> Depending how the cable operator chooses to offer ESPN, a subscriber may have to purchase or rent a converter box to descramble the signal whereas they may not require a converter box currently. This additional cost and inconvenience will also tend to reduce a la carte subscriptions.

<sup>5</sup> *Kagan Media Index*, Jan. 28, 1998, p. 9.

advertising.<sup>6</sup> Cable operators will have to make up not only for lost subscriber revenues but also for lost advertiser revenues. Both factors will put pressure on the operator to maintain the tier rate.

Consider now the effect of such a restriction on the distribution cost. If subscribers can buy some channels a la carte, some will buy the same number of channels that they purchase under the package-only scenario, others will buy less, but nobody will buy more channels. It is obvious then that the average number of channels per subscriber will always be smaller under the restriction than under the package-only system. Indeed, this seems to be the object of the proposal. Since the distribution cost per household is usually the same regardless of the number of channels actually being delivered, the average distribution cost per channel will always be larger under the restriction. In any case, because of the efficiencies and synergies of bundling, the cost to the consumer of re-creating the bundle will certainly increase.

Consumers of the remaining bundle who do not subscribe to ESPN would not necessarily be better off because of a lower price. An implicit assumption here is that removing ESPN from the bundled tier will lower the price of that tier by at least the amount ESPN charges cable operators. In fact, for all of the reasons discussed above it is very likely that bundled tier rates will not fall by that much. Higher transaction costs, higher equipment costs, and increased subscription prices necessary to offset lost advertising revenue will all tend to increase the cost to the consumer of acquiring the two unbundled elements.

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<sup>6</sup> *Kagan Cable TV Advertising*, May 29, 1997.

### III. Cable Television Rates

Late last year, the Federal Communications Commission ("FCC") released the results of its survey of cable industry rates covering the period from July 1, 1995 to July 1, 1997.<sup>7</sup> The survey found that the average monthly rate charged by systems that do not face "effective competition" (as the 1992 Cable Act defines that concept) increased by 8.8 percent between 1995 and 1996, and by 8.5 percent between 1996 and 1997.<sup>8</sup> These increases are perceived by some to be large because during the same periods the Consumer Price Index ("CPI") increased by 3.0 percent and 2.2 percent. But this differential between the increase in the monthly rate and the CPI does not signify market power or justify regulatory intervention.

First, the increase in cable rates is not explained by the exercise of market power. For the group of operators that face effective competition, and hence are exempt from regulation, the survey found that the average monthly rate rose by 8.7 percent between 1995 and 1996 and 9.6 percent between 1996 and 1997. Since these systems raised rates by roughly the same percentage as cable operators that did not face effective competition, the rate increases cannot be ascribed to market power.<sup>9</sup>

Many of the cable systems that do not face effective competition are subject to regulation and can only raise rates in accordance with FCC rate regulations. Thus, the rate increases for many systems occurred within the strictures set out by the FCC. However, even those cable systems that

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<sup>7</sup> "Report on Cable Industry Prices," In the Matter of Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992, MM Docket No. 92-266, Dec. 15, 1997.

<sup>8</sup> The average rate is for the basic service tier (BST), the cable programming service tiers (CPST), a remote control and a converter box.

<sup>9</sup> The term "effective competition" is defined in the 1992 Cable Act and is a legal definition. Under the 1992 Cable Act, systems deemed to face effective competition are exempt from regulation. The FCC adopted the difference between rates charged by systems facing effective competition and systems not facing effective competition, after controlling for other factors, as the basis of its 1993 and 1994 cable rate rollbacks.

neither face effective competition nor are actively being regulated had rate increases comparable to systems that were subject to either regulation or effective competition. Since cable systems subject to regulation experienced rate increases almost identical to systems facing effective competition, the recent rate increases do not imply any need to adopt additional regulations. One goal of the FCC's regulation of cable rates was to make regulated systems fall into line with systems facing effective competition. That goal appears to have been achieved with respect to the recent rate changes.

Second, the mere fact that cable rates have increased faster than the CPI does not, of itself, suggest the need for regulation. It should be remembered that an inflation rate, such as the change in the CPI, is the average of changes in prices of many goods. Approximately half of all prices will increase at rates faster than the rate of inflation. For example, while the CPI increased by 5.2 percent from July 1995 to July 1997, prices of individual items, including breakfast staples such as coffee (11.5 percent), eggs (16.1 percent), bacon (45.4 percent), white bread (10.5 percent), and butter (31.3 percent), increased at a faster rate. During this time cable rates as measured in the CPI index increased by about 14.9 percent. Other goods and services that also experienced price increases greater than that of the CPI over this period include intra-city public transportation (12.0 percent), fuel oil (9.3 percent), college tuition (11.6 percent) and school books and supplies (11.6 percent). Another example of a double-digit rate increase is America Online's recently announced 10 percent increase in its monthly fee for unlimited access to its on-line service.<sup>10</sup> As with cable television, however, the AOL price increase cannot be evaluated without adjusting for the increased quantity and quality of services offered.

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<sup>10</sup> "AOL Plans 10% Rise In Monthly Access Fee," *The Washington Post*, Feb. 10, 1998, p. C1.



To evaluate whether cable prices increased unduly it is necessary to correct for quality improvements such as additional channels and better programming, as well as improved transmission quality and new services stemming from system upgrades. Once these corrections are taken into account, one cannot fairly conclude that rates increased unduly or that regulatory intervention is required.

### **Additional Channels and Higher Quality**

According to the FCC's survey, both operators of cable systems facing effective competition and those not facing effective competition attribute most of their rate increases to inflation, channel additions, increases in programming costs, and system upgrades. With respect to channel additions, the FCC survey found that subscribers to systems that did not face effective competition received, on average, 44 channels in July 1995, 47 channels in July 1996, and 49.4 channels in July 1997. The survey found that subscribers to systems that did face effective competition received, on average, 38 channels in July 1995, 39.6 channels in July 1996, and 46.5 channels in July 1997.

While cable rates have increased, the package of cable services purchased also has changed. Looking only at what is paid without controlling for what is purchased is comparable to saying that a gallon of milk is a bad buy because it costs more than a quart of milk. One way to control for the quantity and quality of what is purchased is to compare prices on a per-unit basis. Unit pricing in grocery stores provides a way to compare the prices of a gallon of milk and a quart of milk by expressing both prices on a per-ounce basis. Unit pricing does not endorse any particular size package but provides a comparable basis to measure costs.

One way to control for the quantity and quality of what is being purchased by cable subscribers is to look at rates per channel rather than overall rates. The FCC's reports on cable prices include analyses of the average monthly rate per channel because this provides a comparable way

to measure the services received by cable subscribers. Even though the rate per channel is not a perfect measure of subscriber value, it does serve as a proxy for a quantity and quality adjustment and permits a comparison of rates across systems and over time on a comparable basis.

According to the FCC survey, the average rate per channel has increased slightly for systems that do not face effective competition. The FCC survey reported that the average rate per channel was \$0.60 in July 1995, \$0.61 in July 1996, and \$0.63 in July 1997. Adjusting for inflation, however, the average rate per channel in real terms did not increase from July 1995 to July 1997. The FCC reported that the average rate per channel on systems that do face effective competition increased from \$0.67 in July 1995 to \$0.70 in July 1996, and then decreased to \$0.66 in July 1997.

The average monthly rate per channel reported in the recent FCC survey is not directly comparable to rate-per-channel figures reported by the General Accounting Office ("GAO") and the FCC during the 1980s. In its recent survey the FCC defined the average rate to include the subscription rate to the basic and CPS tiers of service, a remote control, and a converter box. The historical estimates included only the tier subscription rates. However, using the FCC's recent survey data on the cost of programming services and channels it is possible to estimate the average rate per channel including only the tier subscription fees for 1996 and 1997. The FCC's 1997 survey did not request programming services and equipment charges separately for 1995.

The following table presents the nominal and the inflation adjusted rate per channel for 1984 through 1991 and for 1996 and 1997. The table is based on data from GAO and FCC surveys. The analysis for 1996 and 1997 is limited to those systems that do not face effective competition. As the table shows, the rate per channel, adjusted for inflation, has declined significantly.

**Average Subscriber Monthly Charge  
Per Channel for Programming Services**  
(basic and most popular cable programming services tiers)

<u>Date</u>	<u>Nominal \$</u>	<u>Real 1997\$</u>
12/31/84	\$0.43	\$0.65
12/31/85	0.43	0.63
11/30/86	0.44	0.64
12/31/87	0.45	0.63
12/31/88	0.47	0.63
12/31/89	0.49	0.62
4/1/91	0.53	0.63
7/1/96	0.52	0.53
7/1/97	0.53	0.53

Sources: GAO *Survey of Cable Television Rates and Services*, various years; FCC Report on Competition, Rate Deregulation and the Commission's Policies Relating to the Provision of Cable Television Service, MM Docket 89-600, July 31, 1990; FCC Report on Cable Industry Prices, MM Docket 92-266, December 15, 1997. The FCC's 1997 survey did not request separate programming services and equipment charges for 1995.

Cable operators add channels for several reasons. One reason is that operators hope to attract additional subscribers by expanding program offerings. Another reason is to prevent the loss of subscribers to competition from satellite transmission services such as DirecTV. Cable system operators have repositioned their services in a number of ways to reduce the differences between cable and satellite services. For example, cable operators have moved formerly pay services such as The Disney Channel and regional sports channels to their service tier in response to similar treatment of these channels by satellite providers. Also, cable operators have accelerated the expansion of their channel capacities since the introduction of direct satellite service, although competition from satellites probably is not the sole explanation for this acceleration.

Regulatory authorities themselves apparently believe that subscribers want more channels. The FCC established its going-forward rules to "provide cable operators with additional incentives to expand their facilities and services in a way that both ensures that cable rates are reasonable and expands the opportunities for cable programmers to reach viewers."<sup>11</sup> The 1992 statute was written with the view that offering more program options was beneficial to subscribers. Franchising authorities also are requiring system upgrades to make possible dozens of new channels as part of franchise renewal agreements.<sup>12</sup>

Higher cable rates accompanied by valuable new services, of course, do not necessarily imply that subscribers are worse off. In response to competition from satellite services as well as other factors, cable operators have increased the quality of their service packages. This has increased the costs and prices of those packages. When there is an increase in the quality and quantity of a package, subscribers are likely to be better off even when the new package has a higher price than the old one. Indeed, the point of the repositioning by cable operators is to make cable services more attractive.

A strong indication that cable subscribers are not worse off is that cable rate increases have not caused a drop in subscribership, even though consumers now have at least one additional choice for cable network programming, satellites (although satellites do not provide local station rebroadcast). During the period 1986 to 1992, when cable was deregulated, basic cable subscribers increased from 39.7 million at year-end 1986 to 55.2 million at year-end 1992. While the number of homes passed by cable also increased, cable's penetration, *i.e.*, subscribers per

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<sup>11</sup> "Sixth Order on Reconsideration, Fifth Report and Order, and Seventh Notice of Proposed Rulemaking," In the Matter of Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, MM Docket No. 92-266 and MM Docket No. 93-215, Nov. 18, 1994.

<sup>12</sup> See, for example, "Cable TV Upgrades Promised," *Washington Post*, Feb. 21, 1998, p. D1; "Montgomery to Upgrade Cable System: New Agreement Includes \$140 Million Overhaul," *Washington Post*, Feb. 10, 1998, p. B1; and "Arlington Approves Cable TV Proposal," *Washington Post*, June 21, 1998, p. B4.

homes passed, also increased during this time period, from 57.2 percent at the end of 1986 to 61.7 percent at the end of 1992.<sup>13</sup> More recently, cable penetration has increased from 67.0 percent at the end of 1995 to 68.5 percent at the end of 1997.<sup>14</sup> Hence, even during periods of alleged rapid rate increases the number of subscribers to cable has increased and cable's penetration has increased. Subscriber growth during periods of cable rate increases clearly supports the conclusion that the quality and quantity of cable services being purchased also increased.

### Programming Costs

Programming costs are another factor to consider in understanding cable rates. According to the FCC survey, cable operators report that about 33 percent of the rate increase from 1995 through 1997 on both effectively competitive and non-effectively competitive systems is due to increases in programming costs and licensing fees. Programming costs rise when there is an increase in demand for scarce resources, such as film, music, or sports stars. Cable programmers must compete against other media for the rights to popular attractions such as movies and sports events. Costs also increase when there is an increase in program quality required for programmers to remain competitive. The history of syndication fees for popular sitcoms, movie licensing rights fees, and sports rights fees demonstrates that no cable programmer has market power vis a vis programming inputs. In a competitive environment, individual programmers have little control over prices, including the price of sports rights.

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<sup>13</sup> See, Hazlett, Thomas and Matthew Spitzer, *Public Policy toward Cable Television*, MIT Press and AEI Press (1997), p. 86. They found that the deregulation of cable rates after 1986 did not appear to result in a restriction of output. While cable rates clearly rose, programming quality, service quality, or both rose sufficiently to more than offset such rate increases so households were more, not less, likely to subscribe.

<sup>14</sup> *Kagan Media Index*, Jan. 28, 1998, pp. 8, 14.

There is evidence that part of the increase in programming costs paid by cable operators is explained by increased quality of programming on cable networks. The quality of programming is difficult to measure directly, but there are indirect indicators of quality. Two such indicators are viewers' preferences and program expenditures. The share of viewing captured by basic cable networks has steadily increased. During the 1991-92 broadcast year, just prior to regulation, basic cable networks had a 35 share of viewing in cable households. This increased to a 43 share in 1995-96 and to a 46 share in 1996-97.<sup>15</sup>

During the same time period, cable networks have increased their expenditures on programming. They have increased their purchases of recent off-network syndicated programming, developed original movies, and acquired additional sports rights. Basic cable network programming expenses have increased from \$1.4 billion in 1990 to \$2.2 billion in 1993 to \$3.0 billion in 1995 to \$4.0 billion in 1997.<sup>16</sup> Adjusted for inflation, there has been a 133 percent increase in expenditures on programming by basic cable networks since 1990.<sup>17</sup>

Examples of cable networks aggressively seeking high quality programming include Turner going after the off-network rights to *Seinfeld*, USA Network obtaining the rights to *Wings*, and cable networks getting the rights to major theatrical pictures prior to the broadcast networks. "As TBS makes the conversion from a superstation to a basic cable outlet it is increasing its efforts to get marquee-value off network programming."<sup>18</sup> Other examples include Warner Bros.' *Drew Carey* and *The Parent 'Hood* going to TBS in their first cycle three years after their fall

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<sup>15</sup> *Cable TV Facts*, Cabletelevision Advertising Bureau, various issues.

<sup>16</sup> *Cable TV Facts, 1998*, Cabletelevision Advertising Bureau, p. 5.

<sup>17</sup> Accounting for the growth in the number of cable networks since 1990 by expressing expenditures on a per basic cable network basis, the average inflation adjusted expenditure per network increased by 16% over this period.

<sup>18</sup> "Second cycle strong for 'Seinfeld' sales," *Electronic Media*, Jan. 19, 1998, p. 5.

1999 premiere, and *Friends* going to TBS in the third year of its off-network availability.<sup>19</sup>

## Cable Regulation

The cable industry has been regulated and deregulated several times in recent decades. Currently, cable rates are subject to regulation by the FCC. During 1993 and 1994, the FCC reduced cable rates almost across the board by 17 percent and established a procedure for passing through subsequent cost increases and fees for new services. The 17 percent rate reduction was intended to eliminate any monopoly profits for cable operators not subject to effective competition. The Commission's going-forward rules regarding rate increases from adding channels and rate adjustment schedules were adopted to ensure that rate increases reflect cost increases rather than monopoly returns and yet still provide operators with an incentive to add channels.

The Telecommunications Act of 1996 established a March 1999 sunset date for regulation of non-basic tier cable channels.<sup>20</sup> Rates for the basic service tier will remain regulated. Regulatory sunset reflects recognition of two factors. First, new multichannel video competition, especially from direct satellite broadcasters, such as DirecTV or EchoStar, is becoming established. Direct-to-home satellite transmission already has surpassed 10 percent market penetration in the United States.

Second, as has been amply demonstrated in many industries (airlines, trucking, banking, energy, and telephony), regulation tends to introduce distortions and disincentives that outweigh the problems

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<sup>19</sup> *Id.* and "Offnet sitcoms: A look ahead," *Broadcasting & Cable*, Jan. 19, 1998, p. 50.

<sup>20</sup> The basic tier includes, at a minimum, local television broadcast stations and public, educational and governmental access programming. Subscription to the basic tier is required for access to any other tier of service. Non-basic tier channels are all channels and service tiers other than the basic tier.

regulation was intended to remedy.<sup>21</sup> Airline regulation created excess capacity and raised passenger fares. Trucking regulation led to wasteful "empty backhauls" and rate bureaus. Restrictions on maximum interest rates paid on savings accounts cost consumers millions. Regulation of natural gas wellhead prices caused shortages and higher prices for consumers. And the old regulated monopoly system for telephone equipment and long distance service kept prices high and technological innovation slow.

Imposing new regulations on the cable industry is likely to result in potentially harmful side-effects. For example, after the initial FCC rate regulations took effect in 1993 there was a virtual freeze on the addition of new cable channels by cable operators. At that time, there were close to 100 proposed new cable networks hoping to launch. Given the initial rate structure established by the FCC, cable operators were unwilling to add new channels and many cable network launches were postponed. As a result, the Commission adopted the going-forward rules. Today, there are still dozens of new cable networks that are hoping to launch. Imposing new regulations again may deter cable operators from adding new networks to their systems or inhibit them from upgrading their systems.

Another distortion caused by rate regulation is the disincentive to maintain product quality. The re-regulation of cable rates following the 1992 Cable Act was accompanied by a dramatic drop in viewer ratings for basic cable services and slowdown in cable penetration, suggesting a loss of quality in the eyes of consumers.<sup>22</sup> Some of this loss may be attributable to the re-tiering and shuffling of cable networks as a result of responding to the price regulations and the must-carry rules. The loss may also be partly due to the slowdown in the addition of new cable networks. Ratings and penetration rates began to pick up in 1995 after the regulatory turmoil had settled and the FCC revised its "going-forward" rules.

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<sup>21</sup> See Noll, R.G. and B. M. Owen, eds., *The Political Economy of Deregulation*, AEI (1983).

<sup>22</sup> See, Hazelett and Spitzer, *op. cit.*



History provides one clue to the likely effects of deregulation. The cable television industry was deregulated from approximately 1984 to 1992. One would expect a non-regulated monopoly to raise prices and to reduce output. Just the opposite happened. Cable rates, measured on a real per-channel basis, fell. Output, whether measured by number of subscribers, by number of channels, or by expenditures on programming, increased. Cable networks' share of viewing also increased during this period. The 1984-92 period was one in which cable faced almost no multichannel video competition. DirecTV did not begin operation until 1996. Telephone companies did not begin to operate MMDS services until 1997. Based on this experience, there is every reason to believe that cable's performance will be enhanced by deregulation.

There is no basis to postpone sunset and to continue cable rate regulation. As noted, regulation may not be providing any net benefit to consumers because, even if it limits some rates, it may distort others and reduce the quantity or quality of service. Cable was deregulated in 1984, re-regulated in 1992, and partially deregulated in 1996 (to be effective in 1999). Yet another change in the regulatory status of cable will increase the perceived riskiness of the industry. The result will be an increase in the cost of capital, which will reduce investment, restrict output, and raise prices. At a time when the government is encouraging growth in electronic communication such as the Internet, and when competition in local telephone service is needed, reducing the flow of capital to the cable industry is not sound public policy.